

Internal Revenue Service

Department of the Treasury

District
Director

Baltimore District

31 Hopkins Plaza, Baltimore, Md. 21201

▷

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

Person to Contact:

Contact Telephone Number:

Refer Reply to: EO:T

Date: MAR 01 1999

CERTIFIED MAIL

Dear Applicant:

We have considered your application for recognition of exemption under section 501(c)(3) of the Internal Revenue Code and have determined that you do not qualify for exemption under that section. Our reasons for this conclusion and the facts upon which it is based are explained below.

The information provided shows that the organization was incorporated on [REDACTED] and operates on a calendar year basis. It is successor to a for-profit, previously operated as a sole proprietorship and now operated by the for-profit owner and her family. The organization's activity consists of providing day care for children through age four.

In describing its activities, the application stated that it is a day care and learning center. The purpose of which is to provide care for children ages infant to 12 years old, from Monday through Friday from 6:00 a.m. to 6:00 p.m. Such services are for parents who are working or in school for the objective of gaining employment.

The [REDACTED] provides two meals and three snacks. Children are placed in age appropriate learning groups. Skills are taught by the caregivers who have met those requirements set forth by the Department of Social Services of the State of [REDACTED] for all [REDACTED] Licensed Day Care Centers. All requirements must be renewed annually for state approval.

The organization's income consists of parent fees and state funded programs, (i.e. Project Independence and Block Grant "Child Care Assistance"). Analysis of the organization's financial statements indicate amounts reported for the periods ending December 31, 1993 through December 31, 1996. There was no budget information provided as of the date the non-profit organization was formed, however, information solicited concerning the nature of the expenditures reported, reflect the following:

EO:T
[REDACTED]

[REDACTED]
[REDACTED]

Salaries	\$ [REDACTED]
Leases expenses	\$ [REDACTED]
Groceries	\$ [REDACTED]
Energy	\$ [REDACTED]
Telephone	\$ [REDACTED]
Office and Teaching Supplies	\$ [REDACTED]
Alarm and Monitoring and Leasing	\$ [REDACTED]

The balance sheet showed an asset balance of \$ [REDACTED] and liabilities of \$ [REDACTED] with a net loss of \$15,952.56.

Section 501(c)(3) of the Internal Revenue Code provides for the exemption of organizations which are organized and operated exclusively for charitable, religious, and educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income tax regulations provides that in order to qualify for exemption under Code section 501(c)(3), an organization must be both organized and operated exclusively for one or more exempt purposes. Failure to meet either the organizational test or operational test will disqualify an organization from exemption under section 501(c)(3).

Section 1.501(c)(3)-1(c)(1) of the Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplishes such purposes. An organization will not be regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) states that an organization is not organized or operated for any purpose under section 501(c)(3) unless it serves a public rather than a private interest. Thus, to meet the requirements of this subparagraph, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization or persons controlled, directly or indirectly, by such private interests.

Moreover, even though an organization may have exempt purposes, it will not be considered as operating exclusively for such purposes if more than an insubstantial part of its activities serve a private interest. Revenue Ruling 76-441, C.B. 1976-2, 147 held that an otherwise qualifying nonprofit organization that purchases or leases at fair market value, the assets of a former for-profit school and employs the former owners at salaries commensurate with their responsibilities was operated exclusively for educational and charitable purposes. However, an organization that takes over a school's assets and liabilities, which exceed the value of the assets, is serving private interests and is not operated exclusively for educational and charitable purposes.

A [REDACTED]
[REDACTED]

In Hancock Academy of Savannah, Inc., 69 TC 488, Dec. 34,791, a nonprofit corporation formed to take over the educational functions of a for-profit corporation did not qualify as an exempt organization. The private inurement prohibition was violated where the nonprofit corporation assumed excessive liabilities.

John Marshall Law School, CtCl's, 81-2 USTC@9745 did not qualify as an exempt organization since a portion of the organization's net earnings inured to the benefit of the private individuals who operated the organization and to their families.

Beth-El Ministries, Inc., DC D.C., 79-2 USTC@9412 was determined not to be tax exempt because a part of its net earnings was used to pay for the living expenses of the members of the organization.

Information submitted with your application indicates the organization is operated by [REDACTED], owner and founder of the organization. The initial governing body as listed on Form 1023 included [REDACTED], [REDACTED], [REDACTED], and [REDACTED]. [REDACTED] and her husband [REDACTED] own the real estate that houses the day care center and the equipment used by the center. The real estate consists of two separate properties. One of the properties is located at [REDACTED], and the other is located at [REDACTED]. The property at [REDACTED], according to the appraisal submitted, is not zoned for commercial use but rather, described as a two family residential. The property at [REDACTED] is a double dwelling which has been changed to permitted use as a day care center. The appraisal form indicates the property at [REDACTED] has been upgraded to include a new five ton central heating and air conditioning system and a security system. There is no indication that the property at [REDACTED] has new central heating and air conditioning or a new security system.

The organization has entered into leases for the use of facilities and furniture with [REDACTED], the founder's husband. The real estate lease provides that the applicant pays \$[REDACTED] per month for tenancy. The applicant provides that these payments take into consideration loans made when the [REDACTED] was a sole proprietorship which include a line of credit, and a U.S. Small Business Loan (for flood damage and financial loss due to the Center being closed). The [REDACTED] personal residence was used as collateral. The lease takes into consideration the leasing of furniture and equipment that was at the Center and the use of storage space for equipment not in use and the use of a play yard at [REDACTED]. The lease also includes reimbursement to the [REDACTED] for any maintenance on the buildings, including all minor repairs and upkeep of the property.

[REDACTED]
[REDACTED]

Your clarification of expenditures, while not broken down per year or for periods prior to incorporation, reveal that the expenses are essentially those of the sole proprietorship and/or perhaps those of a purely personal nature. The list included gas and electricity, sewage and water, [REDACTED] and [REDACTED], alarm monitoring and leasing. The explanation did not provide any allocations or prorated amounts.

Our review of the information indicates that while your organization meets the organizational test required to be exempt under section 501(c)(3), you have not established that you are operated exclusively for educational or other stated purposes under section 501(c)(3).

The lease arrangements constitute inurement and private benefit since the income from the nonprofit organization is used to pay off the personal debts of the [REDACTED]. The organization appears to have been created to serve the private benefit of the founders who have transferred liabilities from the sole proprietorship to the nonprofit organization and who still control the nonprofit organization. In addition, the original governing body is in a position to personally gain from the transactions since they were the owners of the for-profit entity. Such private benefit violates the direct proscription against net earnings inuring to private individuals as well as the requirement that the organization be organized and operated exclusively for exempt purposes.

Based on the evidence submitted, we have determined that you have not demonstrated that you are operated exclusively for educational or other purposes described in section 501(c)(3) of the Code. Therefore you are not entitled to exemption under section 501(c)(3). As a result of this determination you are required to file Federal Income tax returns on Form 1120. Contributions to your organization are not deductible by donors under section 170(c)(2) of the Code.

In accordance with the provisions of section 6104(c) of the code, a copy of this letter will be sent to the appropriate State officials.

If you do not agree with our determination, you may request consideration of this matter by the Office of Regional Director of Appeals. To do this, you should file a written appeal as explained in the enclosed Publication 892. Your appeal should give the facts, law and any other information to support your position. If you want a hearing, please request it when you file your appeal and you will be contacted to arrange a date. The hearing may be held at the regional office, or, if you request, at any mutually convenient district office. If you will be represented by someone who is not one of your principal officers, that person will need to file a power of attorney or tax information authorization with us.

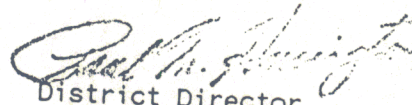
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If you don't appeal this determination within 30 days from the date of this letter, as explained in Publication 892, this letter will become our final determination in this matter. Further, if you do not appeal this determination in a timely, manner, it will be considered by the Internal Revenue Service as a failure to exhaust administrative remedies. Section 7428(b)(2) of the Code provides, in part, that "A declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims court, or the district court of the United States for the District of Columbia determines that the organization involved has exhausted all administrative remedies available to it within the Internal Revenue Service.

Appeals submitted which do not contain all the documentation required by Publication 892 will be returned for completion.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,


District Director
Southeast Key District

Enclosure: Publication 892